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SUBJECT: New Property Measures Should Have Little Immediate  
Effect on South China

REF: A) Guangzhou 17422

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11. (SBU) Summary: The Central Government recently announced six new measures to guide property development and the real estate market. The government hopes that measures on transparency, capital gains tax and increased low-income housing development will help slow down rising property prices. Thus far the laws have had only a slight effect in Guangdong province, which has some one of China's most expensive real estate zones. Guangdong property consultants are not advising any changes in their development strategies and believe the law might create more damage than benefit because of mismanagement at the local level. End summary.

#### Background on the National Measures

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12. (U) Housing prices throughout China have been rising rapidly in the past few years. In April, the National Development and Reform Commission reported property prices in 70 of China's largest cities rose an average of 5.6 percent year-on-year in March. Prices in several cities rose more than 10 percent. For example, in the first quarter of last year, Beijing and Shanghai prices rose by 8.2 percent 5.4 percent respectively. In South China, Guangzhou prices rose by 10.73 percent while Shenzhen rose by 16.3 percent, the second highest in China. The average urban resident has to spend 13 years of salary to acquire a flat of only 70 square meters, double the international average of six to seven years. Some Chinese refer to the concept of "fangnu" or mortgage slave to those who spend more than 50 percent of their income on mortgage (economists say spending 33 percent of a salary on mortgage is typically the maximum allowed by banks). Zou Tao, a Shenzhen-based activist for property law improvement, captured national attention and the support of many middle-class Chinese when he wrote an open letter on the internet petitioning for a three-year property boycott throughout China (see ref A).

#### Economics of the Market in Guangdong

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13. (SBU) Local analysts point to several reasons for the rapid rise in real estate prices in Guangdong, some of which

mirror national trends. A shortage of land, particularly in downtown areas, has led to an increase in land prices. On the outskirts of cities such as Guangzhou and Shenzhen, where factories abut farms, land prices are increasing as well. Rising land and real estate prices have led to an increase in the number of speculators. Without active or open capital markets such as stocks and bonds, these speculators see real estate as the most profitable form of investment. In addition, developers are devoting a larger proportion of their projects to luxury apartments, because the additional space and amenities can fetch profits far beyond the costs. Finally, the effect of China's rising GDP on prices has been exaggerated in Guangdong, where GDP rose 12.5 percent in 2005 -- faster than the national average of 9.8 percent.

#### The Bubble: About to Burst or Just a Slow Leak?

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14. (SBU) Many real estate consultants agree that, although current prices do not reflect it, the market is structurally oversupplied with housing. According to economic theory, individuals tend to buy increasingly more expensive property, immediately move into it, and create supply for less expensive housing. The problem in Guangdong Province is that the market is full of "chaofangren", or house hoarders, who buy valuable property and hold the land waiting for the price to rise. Therefore the secondary market has no growth and prices remain high. To worsen the situation, some speculators have bought property with bank loans, on which they have difficulty even paying back the interest. These people are called "jia gao wu shi" (high price, no possession). Given the oversupply of housing,

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real estate consultants predict that in the long-term, housing prices should fall in Guangdong. When this drop happens, many of these land speculators could go bankrupt. A similar situation occurred in Guangdong Province after the 1997-1998 Asian financial crisis. Guangzhou today still has many unfinished apartment complexes and shopping centers that were never completed because a burst in the market bubble undermined construction cash flows.

#### Government Response: National and Provincial

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15. (U) On May 17, in the likely wake of the rising prices, simmering public discontent and fears of a real estate bubble, Premier Wen Jiabao and the State Council unveiled six broad measures. The six measures, which focus on the residential sector, include requirements that at least 70 percent of all new apartments be of no more than 90 square meters, properties sold within five years of purchase will be subject to a capital gains tax, and developers finance 35 percent of a project themselves and begin building within two years. In addition, local authorities must disclose information on housing development.

16. (SBU) Guangzhou Prefecture has already begun seeking to implement some of State Council's measures. On May 24, the Nanfang Daily reported on seven measures adopted by the Guangdong Housing Association to improve the housing situation. The measures included increasing the supply of land for residential apartments and encouraging the construction of small (less than 100 square meters) apartments through the use of financial tools such as interest rates and taxes. The major Guangdong Housing authorities (the Land and Resources Bureau, Housing Administration Bureau and the Housing Association) recently held a closed-door meeting with real estate companies and housing agencies. They reportedly plan to issue new housing policies by the end of June. On May 30, Guangdong Province's Department of Construction announced a 12 percent year-on-year increase in the amount of land available in the

province for commercial development.

#### Property Experts Show Little Concern

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¶17. (SBU) Violet Chen, a Guangdong property consultant for U.S. investors in China, said she is not greatly concerned about the policies. Although the government is providing incentives for low-income housing development, Chen is not advising her clients to build such projects. Medium to large-sized (50-100 employees) Chinese real estate firms, however, have fewer options. Chen says they face three options: either switch out of the residential sector; live with low profit margins; or layoff workers. In the next three years she expects a big price drop, especially in residential apartments. Chen says, when the South China market declines, "it drops hard." Chen predicts a drop of between 20-40 percent. In fact, on May 9, the Director General of the Guangdong Land and Resources Department affirmed that in three years the housing prices will certainly be more "rational".

¶18. (SBU) He Shihong, managing director of Evergreen consultants, a Guangzhou based real-estate consultancy firm with projects throughout China, was also not overly concerned about the laws. Mr. He advises his clients to not change any investment plans immediately. He described how a previous stamp tax law on property transactions was also supposed to change the market, but was never implemented. The current law does not state how long it will be implemented either.

#### Avoiding the Law

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¶19. (SBU) Both Chen and He described how investors could possibly avoid some of the new property laws. For example, in terms of the capital gains taxes, Chen said "most people do not pay attention to the taxes." Typically buyers prefer not to list property as high as they actually paid for it. Some developers are hedging their bets, however, by buying before the deadline. Evergreen consultants mentioned that many new property deals have come in the past few days

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in order to avoid any new tax implications.

Comment: More Harm than Good?

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¶10. (SBU) The new property measures are obviously a part of Hu Jintao's agenda for a "harmonious society". Hu is concerned with the instability stemming from a large income gap between rich and poor and the inability for even middle-class Chinese to afford housing in coastal cities. In a country with such rapid growth and limited investment channels, however, a rise in property prices is almost inevitable. The question is whether property law reform is the proper tool to resolve the problem. South China has already begun to slightly feel the effects of the new regulations. Guangzhou's Land, Resources and Housing Management Bureau said the average cost of housing in the city fell 2.49 percent per square meter in May. In Shenzhen, however, the price continues to rise. Analysts believe that it is difficult to assume the drop in the Guangzhou price is solely related to the new measures.

¶11. (SBU) In general, real estate consultants are very critical of the efficacy of the new laws in the long term. Despite the efforts on the national level, the consultants believe better management is needed on the local level. In terms of low-incoming housing, many developers do not want to take on such projects because the profits are so slim -- approximately three percent. Many of the residents who are eligible to live in the housing are so poor they cannot make payments on time. Even if low-incoming housing is

developed, there will be long waiting times and inconsistencies in distribution. Additionally, low-income measurements are based on "average social incomes". This figure differs greatly between rural and urban areas. Finally, the plan to allow more transparency of projects could also backfire. The measures essentially call for opening up city plans to the public. This will mean developers can easily learn about location for future develop programs and buy up the land accordingly.

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